

# Moscow Financial Weekly

For the Week Ending January 11, 2002  
Treasury Attache's office, US Embassy Moscow

## Highlights This Week

- Tariff increases are set
- VTB expanding into retail
- **Weekly Focus : What's next for Mortgages**

## Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/\$ (MICEX) UTS	30.4399	1.00	1.00
Monetary Base*	R706.4 bln	-0.3	-0.3
CPI	NA	NA	18.6**
International Reserves*	\$36.7 bln	0.55	0.55
RTS Index (end of week)	290.86	5.06	11.85
Refinancing rate	25	0	0

\*For week prior

\*\*2001 figure

## Economic Developments

### Government Announcements

PM Kasyanov announced final 2001 **GDP growth** of 5.2%. Given the deteriorating external environment in the second half of the year, this is an impressive performance.

The new tariff setting agency announced annual natural monopolies' rate increases for 2002 of 26% for Railways (cargo traffic); 32% for RAO UES (electricity); 35% for Gazprom (gas). These rates are higher and earlier than expected, representing a victory for the monopolies but also for reducing implicit subsidies. It also appears that the GOR is more willing to risk pushing up inflation in order to achieve its goals for monopoly tariff reform.

## Banking sector

Vneshtorgbank (VTB), the biggest bank in Russia by IAS capital standards, has prepared a program to develop retail banking. As of last December, the sum of household account balances in VTB amounted to just R4.8 billion (a little over 2% of liabilities), compared with R350 billion in household accounts in Sberbank (60% of liabilities). VTB Chairman Yuri Ponomarev said in a newspaper interview that he sees "a big potential for quality and rapid growth of this line of bank business," although it would require investments of \$10-15 million a year for 3 consecutive years to develop a branch network. Currently Sberbank has 75% of the retail banking market. Alfa-Bank's share is 1.7%, Gazprombank's - 1.4%, Bank of Moscow's - 1.0%, VTB's - 0.9%, Rosbank's - 0.8%.

The CBR recently announced an expansion of its refinancing program to encourage lending into the real sector of the economy. Launched in St. Petersburg in late 2000, CBR provides loans to banks against veksel's (promissory notes) issued by real sector enterprises, claims on loan agreements with such enterprises, and guarantees of other banks used as collateral. This program has now been expanded to cover the Vologda, Leningrad, Rostov, Samara and Sverdlovsk regions, Primorsky krai, the city of Moscow and Moscow region. According to the CBR, the main problem hindering further development of this program is the poor financial standing of enterprises-borrowers.

According to Kommersant-daily, Avtobank, purchased in late 2001 by Siberian Aluminum, Nafta-Moskva and Millhouse Capital, is up for sale again. The paper claims it will be bought by investment banking group NIKoil for mere \$15 million. So far, neither Avtobank nor NIKoil confirmed this statement. However, NIKoil announced that it had signed a "consulting agreement" with Avtobank according to which "both parties would develop distribution of financial products of NIKoil through the retail network of Avtobank and NIKoil consisting of 106 branches and additional offices in Moscow and other regions."

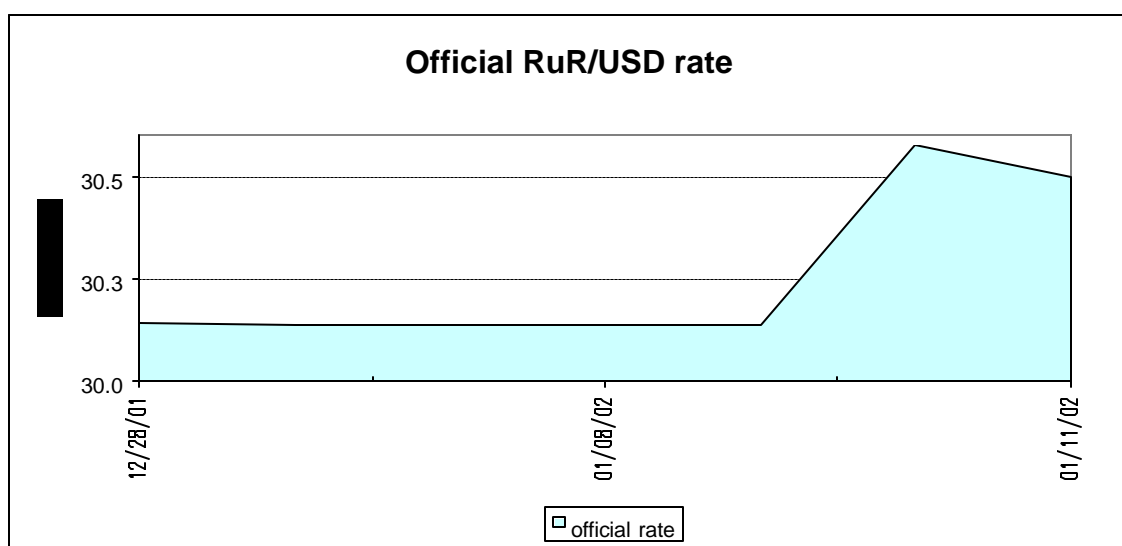
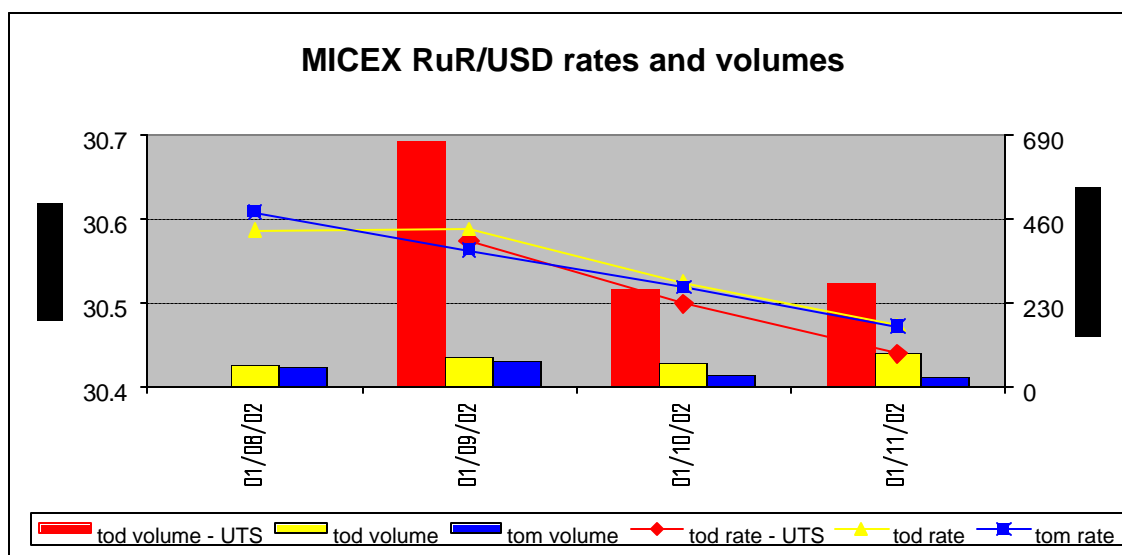
The CBR is going to do a one-time survey of authorized banks and their clients, looking at their investments into securities issued by nonresidents. Banks have to provide the required information by February 25. The data will be used to compile the BOP and the international investment position of the Russian Federation. The CBR promises to keep the information provided by banks confidential and publish only aggregate statistics. The survey is done under the auspices of the IMF as part of the Financial Sector Assessment Program (FSAP).

## **Financial markets**

### **Forex Market**

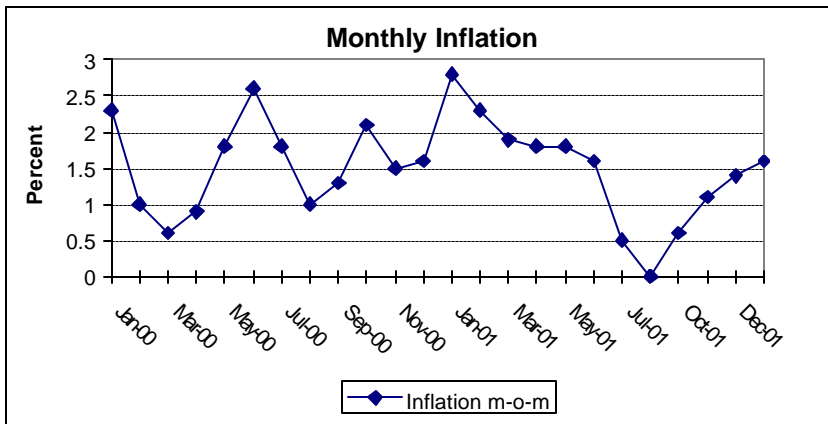
The first UTS session of 2002 opened on January 9 with the dollar being traded around R30.6/\$. Soon after opening, the CBR participated in the trading with an offer at R30.595/\$, and then started shifting its offer down. The CBR sold a reported \$400 million, bringing the trade volume to \$675.38, an unprecedented high for a MICEX morning session. As a result of CBR pressure the rate in the interbank market temporarily moved to R30.4951/\$. However, CBR's intervention failed to discourage the market fully and by the end of the day the interbank rate rose again to R30.58/\$. In the remaining two days of the week the CBR went on intervening in the UTS, selling about \$200 million a day, and gradually lowering the dollar rate. Dealers point out that besides supporting the ruble the CBR also profited from the interventions: at the beginning of each UTS it sold dollars at high rate, but at the end of the day bought dollars back more cheaply, albeit in much smaller amounts.

Since the last UTS of 2001 which took place on December 27 the ruble weakened 1.00%, closing in the UTS on Friday at 30.4399/\$. MICEX weekly trade volumes were \$1229.00 million, \$302.28 million and \$183.61 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.



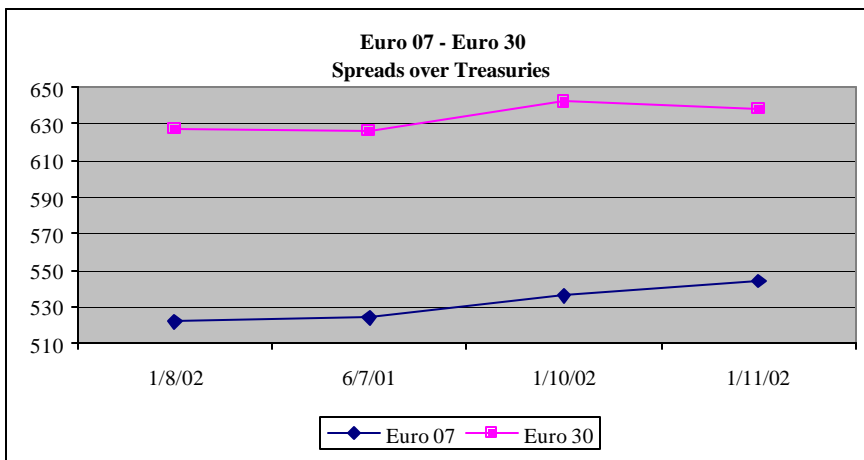
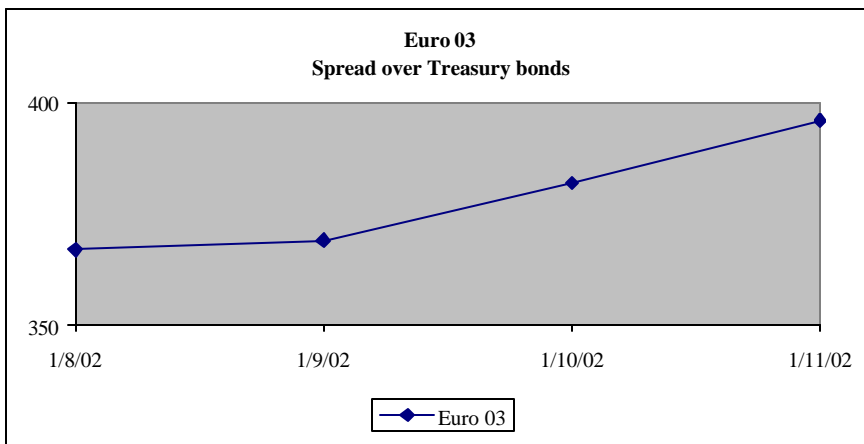
## Prices

Inflation during the first 8 days of January totaled 0.6%. The average daily inflation was 0.07% , which is higher than the average daily rate of 0.051 in December 2001 (inflation for that month was 1.6%), but lower than the January 2001 level of 0.088 when prices grew by 2.8%.



## Eurobonds

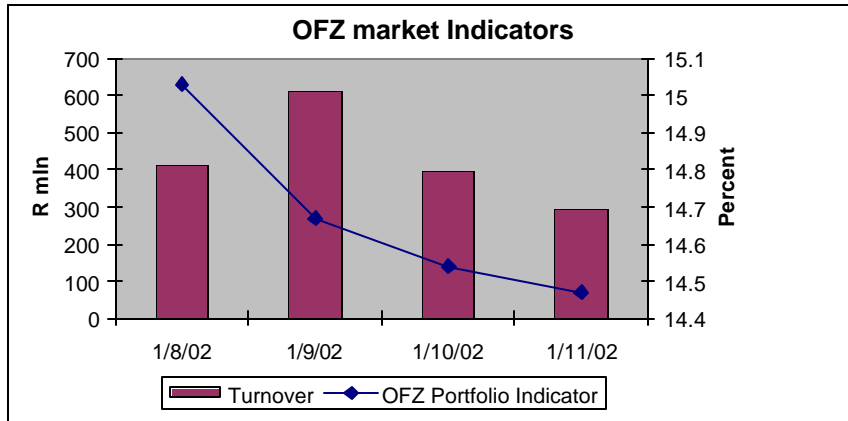
Brokers helped contribute to the general rise in Russian Eurobonds prices by increasing their holdings in anticipation of institutional money inflows in the beginning of the year. The rest of the Eurobond market did not react to these developments.



## Interest/Bond Market

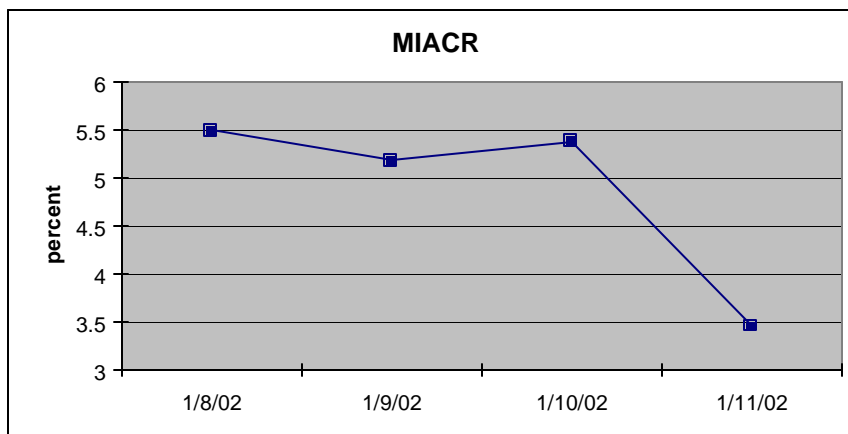
### *Bonds/Bills*

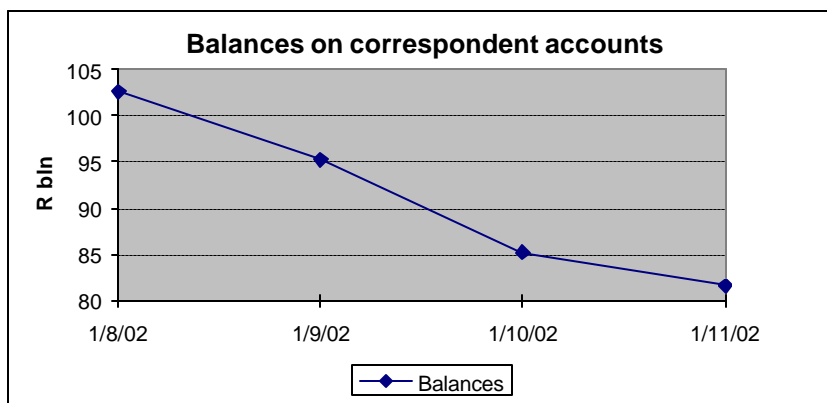
The secondary GKO/OFZ market continued to grow last week. In fact, since the beginning of the year there have been no downward close prices, most likely due to high seasonal ruble liquidity.



### *Overnight rates*

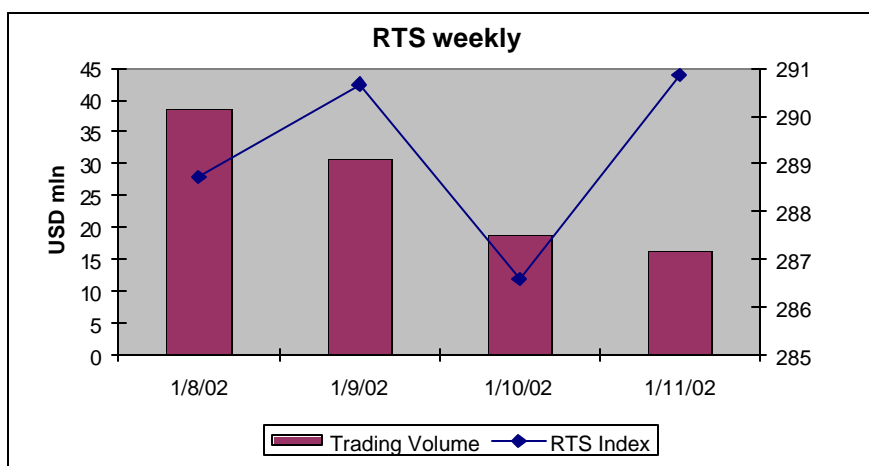
Balances on banks' correspondent accounts at the CBR fell last week finishing the week at R81.6 billion level, which is still above the average. The short-term ruble interbank loan market responded by a sharp decrease in the rates - overnights were down at 3.46 (MIACR) at the end of the week.

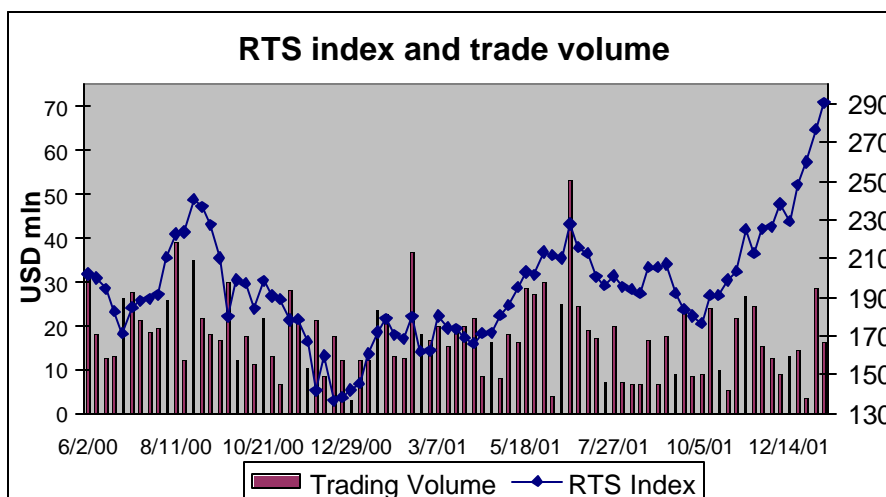
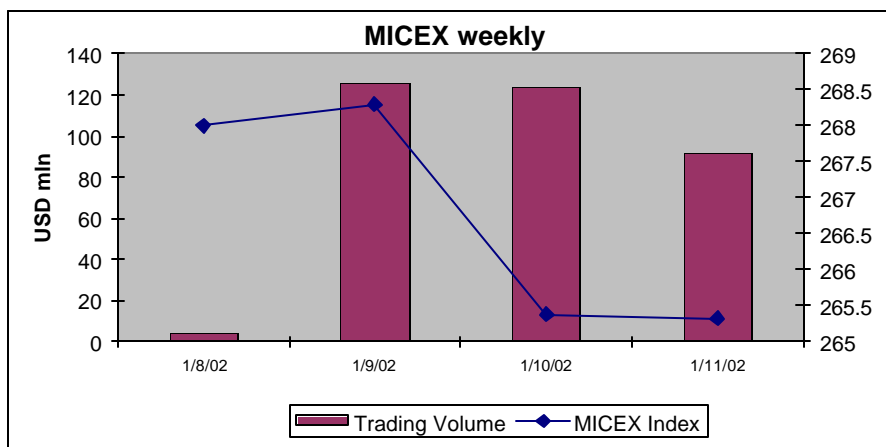




## Stock Market

The stock market opened on an upbeat note on Tuesday (Monday was a Russian holiday) and was up by 4.29% for the day on very high RTS trading volume of \$38.6 - the highest level since the mid-July 2001. After moving slightly further up next day and piercing the 290 level, the RTS index experienced a downturn on Thursday on lower volume of \$18.8 million. On Friday, it was up again and finished the week on the level slightly above 190, which is the highest since May 7, 1998. The RTS index was up by 5.1% in dollar terms over the week.

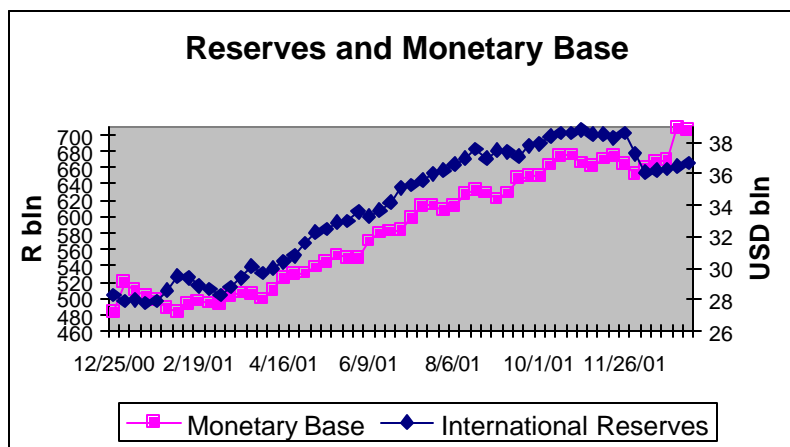




### International Reserves and Monetary Base

International reserves continued to grow during the first week of January and were up by \$200 million, reaching \$36.7 million.

As was expected after the new year, the monetary base began to slide last week and lost R2.1 billion going down to R706.4 billion from a high of R708.5 billion last week.



## **Weekly Focus: What's next for Russia's Mortgage Market?**

While Russia can't count 2001 as a landmark year in terms of financial sector reform, prospects for development of a functioning mortgage market did brighten a bit. Mortgage loan disbursements funded by Delta Credit, the US-Russia Investment Fund's mortgage arm and the largest source of commercial mortgage loans, jumped to \$3.2 million per month, more than its entire credit portfolio up to this year. Other non-bank and governmental programs also began to be more active. Toward the end of the year, amendments to the Mortgage Law and enactment of the Land Code were passed, addressing some key barriers to growth in the sector. Still, the basic problem of inadequate sources of long-term capital remains a major problem that may stunt overall growth. This week we take a look at developments in the mortgage market and assess likely trends in 2002 and beyond.

### Current Status of the Market

There is not comprehensive data on mortgage finance and the different approaches make comparisons difficult.

Delta Credit with a \$20 billion portfolio at the end of 2001 is the market leader for individual mortgages in the classic sense – over ten-year dollar loans at commercial rates (avg. 11.9%), collateralized by the property. Delta has worked through 17 other banks to place and service its loans but, having just gotten its banking license, it is now consolidating these onto its own balance sheet. When this process is finished, the number of Russian banks handling commercial mortgages will drop significantly. Sberbank also provides what it calls mortgages at what appears to be a subsidized ruble rate of 14%. These loans in fact are more like consumer loans, not necessarily collateralized with the property, so they are not really comparable. Finally some pocket banks provide mortgage lending to employees of their financial group but these also imply different credit terms than a commercial mortgage.

Non-banks entities also are involved. Regional governments as well as the city governments of Moscow and St. Petersburg run subsidized mortgage programs. These suffer from a lack of financing and problems with corruption. Construction companies also have provided housing finance by allowing purchase with a delayed payment as long as the purchaser occupies the property.

### Limits to Market Growth

Oddly enough, Delta reports its biggest problem in the short-term is the overly tight housing market in Moscow. It has a bottleneck of pre-approved mortgage applications but the potential borrowers can't find available apartments. This in itself bodes well for market growth.

More fundamentally however, as with leasing and corporate lending, the mortgage market in Russia has been stymied by the lack of long-term capital, due to the banking system's inability to attract long-term deposits or international loans. This in large part has been the reason that Delta, armed with a stable source of lending capital from the U.S. government, has been able to make such in-roads. While solving the systemic

problem of inadequate long-term financing will take years to address, the first order challenge is to build a secondary market for mortgages. This would give lenders a way to manage their balance sheets and long-term investors a way to access the market. A mortgage securities market would set the stage for attracting insurance company reserves and pension funds, currently a negligible factor, but likely to grow substantially. Draft pension reform legislation includes mortgage securities as one of the eligible investment for new personal pension accounts. Plans for such a market have been around for several years and not shown much life. To some extent this reflects a chicken-egg problem: banks will be loath to lend long-term until they know they can sell their loans, but unless there are enough loans to sell, a market can't develop. Estimates are that it will take about \$50 million of tradable loans to start a market. Given current growth rates this threshold is likely to be reached in the next 1-2 years.

The mortgage market is also hampered by the fact that loan officers lack the ability to assess risk properly, particularly on long-term ruble loans. While dollar loans rates are much easier to assess, these strongly favor those with dollar source income due to currency risk. For the market to prosper lenders must have the skills and confidence to lend in rubles.

#### Recent Changes to Legislation

Other problems for the mortgage market look closer to being solved.

Until the Land Code was enacted, lenders faced the problem of having no claim to the land on which their borrower's property was located. Since this presented less of a problem for urban apartments, this has been where mortgages have focused to date. The Land Code, which creates the legal basis on which land rights can be sold, transferred and guaranteed, will dramatically expand the potential market for mortgages, both in commercial real estate and for single family homes and dachas. There is some uncertainty about the initial effects of the new code, but it is sure to provide a positive psychological impact to those that were hesitant to buy or sell land previously due to the murky legal situation. In addition, initial property valuations are likely to be artificially low and thus could lead to strong price gyrations. However over the longer-term mortgages could be a major source of financing for new suburban development.

In addition to the Land Code, late last year the Duma approved an amendment to the mortgage law allowing the eviction of "malevolent" nonpaying clients. The amendment is effective as of January 1, 2002, and permits eviction of residents owing three months worth of payments on their loans. Prior to this law borrowers were required to sign away their right to housing in order to obtain a mortgage. (Article 40 of the Russian Constitution provides a right to housing and a defense against arbitrary deprivation of housing.) This practice was viewed as legally suspect and thus undermined creditors' confidence in their ability to exercise their rights. In addition, families with children had to be provided with alternative housing in order to be evicted. The new law removes what, for the moment, was as much a perceptual problem as a real one. Delta Bank reports nearly a 100 percent payment rate. Still creditor rights will become more important in the future as the real estate market begins to take off and the supply of extremely qualified borrowers dries up.

Finally, changes to the tax code, which came into effect last year, provide much needed clarity to the treatment of mortgage payments. Until 2001, no one knew if principal and interest were deductible or just interest. Mortgage holders who deducted both thus faced the risk of a sudden bill for unpaid taxes if the law turned out to be different. In fact, the tax code only allows interest to be deducted. However, loans issued before the tax code went into effect were grandfathered, ostensibly not penalizing those who deducted both principle and interest. Clarity on this issue will make evaluating credit worthiness and loan cost much easier.

### Room for Subsidized Mortgages?

There has been a fair amount of discussion on the desirability of subsidized mortgage programs. The arguments break down as follows: Those in favor point out that the current pace of commercial growth will take many years to meet potential demand, that Russians are too poor to pay market rates and that banks will tend to ignore the low end of the market. Those who oppose subsidies argue that it will undercut the commercial market, be unsustainable, and in the Russian context likely lead to corruption and favoritism.

The evidence would support some of both arguments. Comparing a newly announced Moscow regional subsidy program to Delta's loan portfolio shows a significant difference in target loan size. The Moscow program envisages average loans between \$5,000-6,000 for 50 percent of the value vs. \$30,000 for Delta. Interest on the loans would be around 12 percent in rubles, about the same as Delta's dollar loans rates (implying a big subsidy). It is also worth noting that, based on the increase in business from last year, Delta plans to move away from the lower-end market and expand into the higher-end market. This would make the subsidy amount even larger. This is not to say that Delta is not targeting a mainstream market; most of its clients have salaries between \$500 to \$1,500, considered middle-class income in Moscow. Still there is clearly room at the bottom; even the program director in Moscow Oblast admits that only about 15 percent of the 240,000 families on the waiting list would be qualified for even the subsidized mortgages.

The problem is making subsidies work. Experience in the regions indicates that these programs generally do not reach their intended targets. This, along with the problem of funding, would favor those who argue against major mortgage subsidy programs.

### Prospects in the medium-term

As with most developments in the financial sector, significant growth in mortgages – especially the question of long-term money - will depend on bank reform. Still, the Land Code and other improvements have the ability to boost the number of loans in the short term, possibly igniting a secondary market and drawing more lenders into the market. Over the longer term, with simultaneous growth of other retail banking services, mortgages could become a staple of a reformed banking system.

## EXPLANATORY NOTES

**1. EXCHANGE RATES:** SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). "\$-tod" price is the price of the dollar with same day delivery. "\$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is \$100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

**2. INTEREST RATES:** Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

**3. STOCK INDICES:** The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

**4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION** represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

**5. MONETARY BASE (M1)** is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

**6. LOMBARD CREDITS,** distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.